REGULATORY FRAMEWORK OF SECURTISATION COMPANIES AND RECONSTRUCTION COMPANIES IN INDIA

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For providing solutions against the rising Non Performing Assets (Hereinafter referred as NPA), the government has constituted Narshimahan Committee, which has recommended for creation of Assets Recover funds to deal with the problem of NPA and bad debts. Accordingly, the Indian Parliament has created regulatory platform for Securitisation Companies and Restructuring Companies (hereinafter referred as SC/RC) under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, (`SARFAESI Act`) with an aim to provide a statutory framework to banks for recovery of bad debt and NPA.

Introduction

At present following 15 SC/RC companies are working in India.[1]

1.Alchemist Asset Reconstruction Company Limited

2. ASREC (India) Limited

3. Edelweiss Asset Reconstruction

4. Asset Reconstruction Company (India) Limited

5. Assets Care and Reconstruction Enterprise Ltd

6. India SME Asset Reconstruction Company Limited

7. International Asset Reconstruction Company Private Limited

8. Invent Assets Securitisation & Reconstruction Private Limited

9. JM Financial Asset Reconstruction Company Private Limited

10. Meliora Arc

11. Pegasus Asset Reconstruction Private Limited

12. Phoenix ARC Private Limited

13. Pridhivi Asset Reconstruction and Securitisation Company Limited

14. Reliance Asset Reconstruction Company Limited

[1] Details available at http://www.arcindia.co.in/.

15. UV Asset Reconstruction Co. Ltd

It is an important contradiction that the business of these securitisation companies are growing and the problem of NPA is also growing in our country. Further, we are hoping to accept BASEL III norms in near future, which will further put more pressure on these securitisation companies to reduce the burden of rising NPA in a systematic manner. Reserve Bank of India (Hereinafter referred as RBI) is the registering and regulating agencies for these securitisation companies. In this light, it is important to see that whether the regulatory framework of these securitisation and reconstruction companies (Hereinafter referred as SC and RC) and the role played by RBI is effective enough to manage the problem of rising NPA.

1. Establishment of Securitisation/ Assets Reconstruction Companies

Securitisation company is defined as "securitisation company" means any company formed and registered under the Companies Act, 1956 (1 of 1956) for the purpose of securitisation[2]. "Reconstruction company" means a company formed and registered under the Companies Act, 1956 (1 of 1956) for the purpose of asset reconstruction. [3] An SC or RC are established and recognised under Sec 3 of SARFESI Act, 2002, which provides following requirements for such companies:

(i) Obtaining the certificate of registration under this section

(ii) Every securitisation company or reconstruction company shall make an application for registration to the Reserve Bank in such form and manner as it may specify.

(iii) The Reserve Bank may, for the purpose of considering the application for registration require to be satisfied, by an inspection of records or books of such SC or RC , or otherwise, that the following conditions are fulfilled, namely:-- (a) that the SC or RC has not incurred losses in any of the three preceding financial years; (b) that such SC or RC has made adequate arrangements for realisation of the financial assets acquired for the purpose of securitisation or asset reconstruction and shall be able to pay periodical returns and redeem on respective due dates on the investments made in the company by the qualified institutional buyers or other persons; (c) that the directors of SC or RC have adequate professional experience in matters related to finance, securitisation and reconstruction; (d) that the board of directors of such SC or RC does not consist of more than half of its total number of directors who are either nominees of any sponsor or associated in any manner with the sponsor or any of its subsidiaries; (e) that any of its directors has not been convicted of any offence involving moral turpitude; (f) that a sponsor, is not a holding company of the SC or RC, as the case may be, or, does not otherwise hold any controlling interest in such securitisation company or reconstruction company; (g) that SC or RC has complied with or is in a position to comply with prudential norms specified by the Reserve Bank. (h) That SC

[2] SARFESI Act, 2002, Sec 2 ZA.
[3] *Ibid* , Sec 2 V.

or RC has complied with one or more conditions specified in the guidelines issued by the Reserve Bank for the said purpose.

(iv) After being satisfied of above said conditions, a certificate of registration may be granted to the SC or the RC to commence or carry on business of securitisation or asset reconstruction, subject to such conditions which it may consider, fit to impose.

(v) The Reserve Bank may reject the application on the basis of non fulfilment of said conditions; however, before rejecting the application, the applicant shall be given a reasonable opportunity of being heard.

(vi) Any substantial change in its management or change of location of its registered office or change in its name of SC or RC can be done on prior approval of the Reserve Bank.[4]

Establishment norms are stricter and RBI has been empowered to register or not to register any SC or RC for the business of securitisation. Further, RBI Guidelines on The Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions, 2003, further provides detailed procedure with respect to their establishment. It provides following essentials:

(i) Every Securitisation Companies(SC) / RC(Reconstruction Companies) shall apply for registration in the form of application specified vide Notification No.DNBS.1/CGM(CSM)-2003 dated March 7, 2003 and obtain a certificate of registration from the Bank as provided under Section 3 of the Act;

(ii) The SCs / RCs seeking registration from the RBI shall submit their application in the format (Annexed to Notification No. DNBS.1/CGM(CSM)-2003 dated March 7, 2003) specified by the Bank, duly filled in with all the relevant annexures / supporting documents to the Chief General Manager-in-Charge, Department of Non-Banking Regulation, Central Office, Reserve Bank of India, Centre 1, World Trade Centre, Cuffe Parade, Colaba, Mumbai 400 005.

(iii) A SC / RC, which has obtained a certificate of registration issued by the Bank under Section 3 of the Act, can undertake both securitisation and asset reconstruction activities;

(iv) (a) A SC/RC shall commence business within six months from the date of grant of Certificate of Registration by the Bank; Provided that on the application by the SC / RC, the Bank may grant extension for such further period, not exceeding 12 months from the date of grant of Certificate of Registration.

(b) Provisions of section 45 -IA, 45-IB and 45-IC of RBI Act,1934 shall not apply to non-banking financial company, which is a SC / RC registered with the Bank under Section 3 of the SARFAESI Act, 2002.

[4] *Ibid*, Sec 3.

(v) Any entity not registered with the Bank under Section 3 of the Act may conduct the business of securitisation or asset reconstruction outside the purview of the Act.[5]

However, RBI is further empowered to cancel the certificates granted under sec 3, if such company—

(a) Ceases to carry on the business of securitisation or asset reconstruction; or

(b) Ceases to receive or hold any investment from a qualified institutional buyer; or

(c) Has failed to comply with any conditions subject to which the certificate of registration has been granted to it; or

(d) at any time fails to fulfil any of the above said conditions referred to section 3 or fails to-- (i) comply with any direction issued by the Reserve Bank under the provisions of this Act; or (ii) maintain accounts in accordance with the requirements of any law or any direction or order issued by the Reserve Bank under the provisions of this Act; or (iii) submit or offer for inspection its books of account or other relevant documents when so demanded by the Reserve Bank; or (iv) obtain prior approval of the Reserve Bank required under subsection (6) of section 3.

However, before cancelling a certificate of registration on the ground that the SC or RC has failed to comply with the said provisions or has failed to fulfil any of the conditions referred, the Reserve Bank, unless it is of the opinion that the delay in cancelling the certificate of registration granted under subsection (4) of section 3 shall be prejudicial to the public interest or the interests of the investors or the securitisation company or the reconstruction company, shall give an opportunity to such company on such terms as the Reserve Bank may specify for taking necessary steps to comply with such provisions or fulfilment of such conditions. [6]

A securitisation company or reconstruction company aggrieved by the order of cancellation of certificate of registration may prefer an appeal, within a period of thirty days from the date on which such order of cancellation is communicated to it, to the Central Government.[7]

RBI is empowered to regulate such companies under Sec 12 and 12 A of the Act. Under sec 12 of the Act, Reserve Bank can determine policy and issue directions in matters relating to income recognition, accounting standards, making provisions for bad and doubtful debts, capital adequacy based on risk weights for assets and also relating to deployment of funds by the securitisation company or reconstruction company, as the case

[5] The Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions, 2003, Guidelines 4.

[6] *Supra Note 2 , sec 4.*

[7] *Ibid ,* Sec4.

may be, and such company shall be bound to follow the policy so determined and the directions so issued.[8]

Further, the RBI may give directions to any SC or RC generally or to a class of securitisation companies or reconstruction companies or to any securitisation company or reconstruction company in particular as to-- (a) the type of financial asset of a bank or financial institution which can be acquired and procedure for acquisition of such assets and valuation thereof; (b) the aggregate value of financial assets which may be acquired by any securitisation company or reconstruction company. [9]

Under Sec 12A of the Act, RBI is empowered to call for statements and information. It may direct RC and SC to furnish any information it within such time as may be specified by the Reserve Bank, with such statements and information relating to the business or affairs of such securitisation company or reconstruction company (including any business or affairs with which such company is concerned) as the Reserve Bank may consider necessary or expedient to obtain for the purposes of this Act.[10]

The above said provision provides sufficient control of RBI over these SC and RC. From registering to regulating, the RBI possesses all the important powers to deal effectively with these RC and SC.

2. Functions of Securitization and Assets Reconstruction Companies

A securitisation company basically performs the very important function of converting bad debt into negotiable securities, which is known as securitisation. As per Guidelines, It can only commence / undertake only the securitisation and asset reconstruction activities and the functions provided for in Section 10 of the Act and it shall not raise monies by way of deposit.[11]

Securitisation is defined as “"securitisation" means acquisition of financial assets by any securitisation company or reconstruction company from any originator, whether by raising of funds by such securitisation company or reconstruction company from qualified institutional buyers by issue of security receipts representing undivided interest in such financial assets or otherwise;”[12]

So, SC or RC firstly acquires financial assets from any originator (Bank and financial Institution). It is also known as assets reconstruction. It is defined as “asset reconstruction" means acquisition by any securitisation company or reconstruction company of any right

[8] *Ibid,* Sec 12.
[9] *Ibid.*
[10] *Ibid,* Sec 12 A.
[11] Supra Note 5, Guideline 6.
[12] *Supra note 2*, Sec 2 Z.

or interest of any bank or financial institution in any financial assistance for the purpose of realisation of such financial assistance;"[13]

To carry out the process of assets constructions SC and RC can take following measures:

(a) The proper management of the business of the borrower, by change in, or takeover of, the management of the business of the borrower;

(b) The sale or lease of a part or whole of the business of the borrower;

(c) Rescheduling of payment of debts payable by the borrower;

(d) Enforcement of security interest in accordance with the provisions of this Act;

(e) Settlement of dues payable by the borrower;

(f) Taking possession of secured assets in accordance with the provisions of this Act.[14]

However, The SC / RC shall take the measures specified in Sections 9(a) of the Act, in accordance with instructions contained in Circular DNBS/PD.(SC/RC)No.17/26.03.001/2009-10 dated April 21, 2010 as amended from time to time.[15] Certain measures like Sale or Lease of a part or whole of the business of the borrower cannot be taken without Bank issuing necessary guidelines in this behalf.[16]

After acquiring the financial assets, it converts those assets into securities to be sold to qualified institutional buyers, which includes Bank, financial institution and others. As per Sec 7 of the Act, any securitisation company or reconstruction company, may, after acquisition of any financial asset under sub-section (1) of section 5, offer security receipts to qualified institutional buyers (other than by offer to public) for subscription in accordance with the provisions of those Acts.[17]

A securitisation company or reconstruction company may raise funds from the qualified institutional buyers by formulating schemes for acquiring financial assets and shall keep and maintain separate and distinct accounts in respect of each such scheme for every financial asset acquired out of investments made by a qualified institutional buyer and ensure that realisations of such financial asset is held and applied towards redemption of investments and payment of returns assured on such investments under the relevant scheme.[18]

However, Issue of Security Receipts shall be done through one or more trusts set up exclusively for the purpose. The SC/RC shall transfer the assets to the said trusts at the

[13] *Ibid,* Sec 2 b.
[14] *Ibid,* Sec 9.
[15] *Supra* Note 5, Guideline 2.
[16] *Ibid.*
[17] *Supra note 2,* Sec 7.
[18] *Ibid.*

price at which those assets were acquired from the originator if the assets are not acquired directly on the books of the trust-

(i) The trusts shall issue SRs only to QIBs; and hold and administer the financial assets for the benefit of the QIBs;

(ii) The trusteeship of such trusts shall vest with the SC/RC;

(iii) A SC/RC proposing to issue Security Receipts, shall, prior to such an issue, formulate a policy, duly approved by the Board of Directors, providing for issue of security receipts under each scheme formulated by the trust;

(iv) The policy referred to in sub-paragraph (iii) above shall provide that the SRs issued would be transferable / assignable only in favour of other QIBs.[19]

It may invest a minimum of 15% of the Securities receipts of each class issued by them under each scheme on an ongoing basis till the redemption of all the Securities receipts issued under such scheme.[20]

Further, a SC/RC can utilize a part of funds raised under a scheme from the QIBs for restructuring of financial assets acquired under the relative scheme subject to following conditions:

(i) SCs/ RCs with acquired assets in excess of Rs. 500 crore can float the fund under a scheme which envisages the utilization of part of funds raised from QIBs in terms of Section 7(2) of the SARFAESI Act, 2002, for restructuring of financial assets acquired out of such funds.

(ii) The extent of funds that shall be utilized for reconstruction purpose should not be more than 25% of the funds raised under the scheme in terms of Section 7(2) of the SARFAESI Act, 2002. The funds raised to be utilized for reconstruction (within the ceiling of 25%) should be disclosed upfront in the scheme. Further, the funds utilized for reconstruction purposes should be separately accounted for.

(iii) Every SC/RC shall frame a policy, duly approved by the Board of Directors, laying down the broad parameters for utilization of funds raised from QIBs under such a scheme.[21]

So, the prime function of SC or RC is securitisation. The business of securitisation is growing though it is restricted to Qualified Institutional Buyers.

For the debtor, Bank and financial organisation are substituted with SC and RC. The bank or financial institution may, if it considers appropriate, give a notice of acquisition of financial assets by any securitisation company or reconstruction company, to the concerned

[19] *Supra* Note 4,Guidleine 8.
[20] *Ibid.*
[21] *Ibid.*

obligor. The obligor, on receipt of such notice, shall make payment to the concerned securitisation company or reconstruction company, as the case may be, and payment made to such company in discharge of any of the obligations in relation to the financial asset specified in the notice shall be a full discharge to the obligor making the payment from all liability in respect of such payment.[22]

SC and RC can perform following other functions:

(a) Act as an agent for any bank or financial institution for the purpose of recovering their dues from the borrower on payment of such fee or charges as may be mutually agreed upon between the parties;

(b) Act as a manager referred to in clause (c) of sub-section (4) of section 13 on such fee as may be mutually agreed upon between the parties;

(c) Act as receiver if appointed by any court or tribunal: PROVIDED that no securitisation company or Reconstruction Company shall act as a manager if acting as such gives rise to any pecuniary liability. (2) Save as otherwise provided in sub-section (1), no securitisation company or reconstruction company which has been granted a certificate of registration under sub-section (4) of section 3, shall commence or carry on, without prior approval of the Reserve Bank, any business other than that of securitisation or asset reconstruction: PROVIDED that a securitisation company or reconstruction company which is carrying on, on or before the commencement of this Act, any business other than the business of securitisation or asset reconstruction or business referred to in sub-section (1), shall cease to carry on any such business within one year from the date of commencement of this Act. Explanation : For the purposes of this section, "securitisation company" or "reconstruction company" does not include its subsidiary.[23]

Disputes relating to securitisation or reconstruction or non-payment of any amount due including interest arises amongst any of the parties, namely, the bank or financial institution or securitisation company or reconstruction company or qualified institutional buyer shall be settled by conciliation or arbitration as provided in the Arbitration and Conciliation Act, 1996 (26 of 1996), as if the parties to the dispute have consented in writing for determination of such dispute by conciliation or arbitration and the provisions of that Act shall apply accordingly.[24]

Conclusion

The success of SC and RC shows efficient regulatory framework and effective regulation by RBI. The business of selling and purchasing bad debt and risk requires Proper management of the SR and RC. These companies are mandated to remain themselves away from insolvency and bankruptcy so that they can effectively deal in debt market. Till

[22] *Ibid*, Sec 6.
[23] *Ibid*, Sec 10.
[24] *Ibid,* Sec 11.

date, there has not been any substantive dispute arisen between banks and these SC and RC. However, the problem of rising NPA remains as it is. This shows that Success of these SC and RC have made little impact on Management of NPA in our country. Before implementing BASEL-3 norms, more structural and functional changes are required in the working of these SC and RC.